McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Fourth Quarter 2011 MAM Letter

Wednesday, January 4, 2012

Dear Client,

Despite a strong fourth quarter, most stock market indices finished modestly down for 2011. While U.S. large-cap stocks were slightly positive, smaller cap U.S. stocks fell and most international markets performed very poorly. While I expect the stock market to remain turbulent for the foreseeable future primarily due to the European sovereign debt crisis, I have recently become more optimistic in my outlook for 2012.

This is the MAM Letter for the quarter ending December 31, 2011. I am sending it to provide an update on my investment management services. The minimum amount to manage for new clients is $500,000, although the amount is flexible depending on the individual's situation. In this letter, I will discuss both my reasons for caution for 2012 as well as why I think the stock market could surprise to the upside. This letter discusses:

- Stock Market & MAM Performance for the 4th quarter and full year 2011
- Economic Outlook- A "Fragile Recovery" Progresses into "Moderate Expansion"
- Reasons for Concern in 2012
- Reasons for Optimism in 2012
- Current Portfolio Positioning- Focus on Dividend-Paying Stocks and Use of Bonds to Reduce Volatility

Stock Market & MAM Performance for Fourth Quarter

Unadjusted for dividends, the S & P 500 rose 11.2%, the Nasdaq climbed 7.9%, the Russell 2000 jumped 15.1%, and the international equity index MSCI EAFE rose 2.9%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 1.1% for the quarter.

MAM Portfolio Performance: Excluding the "very conservative" portfolios (which rose 3.2% for the quarter), the composite return of assets in MAM portfolios was a gain of 6.0% (after MAM fees) versus a rise of 11.8% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested.

Stock Market & MAM Performance for 2011

For all of 2011, unadjusted for dividends, the S & P 500 was flat, the Nasdaq dropped 1.8%, the Russell 2000 fell 5.5%, and the international equity index MSCI EAFE dropped 14.8%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 7.9% for the year.

MAM Portfolio Performance: Excluding the "very conservative" portfolios (which rose 2.1% for the year), the composite return of assets in MAM portfolios was a loss of 0.6% (after fees) versus a gain of 2.0% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested.

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Discussion of MAM Portfolio Performance: Although the composite return for MAM portfolios was a loss of 0.6% compared to gain of 2.0% for the Vanguard Index 500 Fund, I am actually satisfied with how portfolios performed given 2011's investment environment. Many U.S. stock indices (including the Nasdaq and Russell 2000) were down for the year. In fact the Dow Jones Total Stock Market Index (which measures all U.S. equity securities that have readily available prices) was down 1.4%. More significantly, international equities were very weak, as indicated by the loss of 14.8% for the MSCI EAFE index. In fact, for 2011 every equity market in the developed world except Ireland underperformed the U.S. Market.

New Report: Included for the first time in your quarterly report is the "Asset Class Performance Summary" which became available from Schwab with the December upgrade to its portfolio management software. The report starts on page five. As shown in the report, for most portfolios, all asset classes rose for the year with the exception of Global (which fell approximately 6%) and International (which fell around 10%). As explained in the letter that was sent out in the November portfolio repositioning, the international allocation was reduced in most portfolios to fund the purchase of the MLP alternative asset fund. Given the concerns of the European debt crisis, while it may seem sensible to completely eliminate international exposure, I think it is best to retain some exposure, particularly with the favorable growth outlook for many of the Asian and emerging market economies. Nonetheless, international stock exposure in portfolios is now the lowest it has been in at least seven years.

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of December 31, 2011, the original $50,000 had risen to $85,438, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 73.3%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 12.5%. For the quarter ended December 31, 2011, the portfolio rose 6.2% and for all of 2012 it fell 0.1%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

Economic Outlook- "Fragile Recovery" Progresses Into Moderate Expansion

Recent economic reports indicate that the U.S. economy has improved from being a "fragile recovery" to a durable, moderate expansion:

- **Improving Employment:** The most recent weekly Department of Labor report showed 381,000 people filed for unemployment benefits for the first time. While that figure was up slightly from the prior week, the more important four-week average fell to its lowest level since June of 2008. At the peak of the 2008 recession initial weekly claims were up close to 700,000.

- **Economists' Predictions for 2012:** In a recent CNNMoney survey of 20 top economists, GDP growth was expected to be 3.3% for the fourth quarter of 2011 and is predicted to moderate to 2.4% for all of 2012. Employers are expected to add 1.6 million jobs for 2012, less than the 150,000 a month needed to keep pace with population growth. While Bob Johnson, Director of Economic Analysis for Morningstar, sees 2012 GDP growth slightly higher than the consensus, he thinks the odds of an upside surprise are substantially higher than a downside surprise. Potential sources of an upside surprise include increased U.S. oil and gas production (which has improved significantly due to dramatic production increases in shale oil and shale gas), a sharper rebound in auto production, and a stronger housing market.

- **Consumer Confidence:** During the second half of 2011, consumer and investor feelings and confidence plunged to levels only seen one other time in the past 30 years: during the financial crisis of 2008-2009. Fortunately, consumers acted better than they felt as GDP growth was 2.0% for the third quarter of 2011. Recently, consumer confidence showed dramatic improvements as the Conference Board announced that its Consumer Confidence Index jumped nearly 10 points in December to 64.5, from a revised 55.2 in November and 40.9 in October.

Reasons for Concern in 2012

European Debt Crisis: Agreements reached last quarter indicate that a near-term implosion in Europe seems to have been avoided, but real solutions remain absent and the risks for a greater economic pullback are growing, which would likely have global implications. The crisis has highlighted the major flaw of the euro—monetary union without fiscal union. While the latest actions of the European Central Bank (ECB) to provide additional support to European banks is treating the symptoms rather than the cause of the crisis, at least it has bought time to allow for the possibility of a fiscal union.

Europe is expected to experience a mild recession in 2012. This is probably priced into the markets and is partly why European stock markets were so weak in 2011. Fortunately, the performance of the European economy shouldn't have too big an impact on the U.S. economy. According to a recent Morningstar report, while exports make up approximately 14% of the U.S. GDP, exports to Europe represents just 3.1% of U.S. GDP. Keep in mind that a portion of these exports are basic necessities, such as food or items that can't be easily obtained elsewhere. So even if Europe were to move into a recession, the drop in U.S. exports to Europe probably won't be large.

China Growth Concerns: China's growth is slowing and the concern is whether policymakers can avert a hard landing. The question is whether policymakers have the foresight and tools to tightly manage growth, or whether the slowdown is out of their hands. So far, the slowdown is driven by a moderation in exports, particularly to Europe, and a reduction in construction spending. Exports, the area of China's economy that policymakers have little ability to influence, are 26% of China's GDP, with Europe comprising 18% of exports. However, a bigger portion of China's economy is construction-related, where the government can influence growth. The Chinese government initiated its housing market slowdown due to fears that prices were spiraling out-of-control. Recently, there have been some initial signs that the Chinese government has shifted back to easing moves to stimulate the economy. It is possible that additional monetary stimulus will be added around the Chinese New Year, on January 23rd. If so, this could spark a recovery in the Chinese stock market. Additionally, China's transition to become more consumer-driven may be evident in 2012. Although China currently derives only one-third of its growth from consumer spending, this is expected to increase over time due to the dramatic growth in its middle class.

Frustrated With U.S. Politics: The failure of the 12-member, bipartisan super committee to come up with $1.2 trillion in deficit reduction by the November 23rd deadline is indicative of my lack of confidence in our leaders in Washington. I feel that both parties are responsible for the ongoing inaction with regards to the unsustainable spending and entitlement programs. Most Republicans have been unwilling to compromise as they hold steadfast to their position that taxes cannot be raised. This is unrealistic as an increase in taxes will need to be part of the long-term solution to our rising fiscal deficits. Meanwhile, the rhetoric coming out of the Administration is not productive. The recent increase in populism, where job-producing businesses and financially-successful Americans are portrayed as what's wrong with America does little to provide incentive or inspiration to risk-takers and innovators, making it harder and more expensive to do business in America. From health care uncertainty to environmental and accounting regulations, the cost of doing business has increased at a time when we need to make it easier to invest in the United States. Unfortunately, I expect little out of Washington until after this November's Presidential election.

Reasons for Optimism in 2012

In spite of the concerns listed above, I have recently become more optimistic in my 2012 outlook for the stock market. Here are some of the reasons for my optimism:

1. **Moderate Economic Growth:** As discussed above, economists currently predict GDP growth a little over 2% for 2012, with employers adding 1.6 million jobs. The increase in new jobs should provide a modest boost to consumer spending. Meanwhile, U.S. business spending is expected to grow at several times the pace of consumer spending. *Moderate economic growth is typically a positive environment for the stock market.* In a recent report titled "Outlook 2012", LPL Financial indicated that over the past 40 years, the S & P 500 median return was 10% when real GDP grows less than 3%.

2. **Record Corporate Earnings:** Stocks can outperform the growth in the economy due to earnings growth and a modest rise in valuations from the recession-like levels we are now at. Corporate earnings reached an all-time record in 2011 and analysts currently project another 6% growth for 2012.

3. **Stocks Are Cheap:** Companies in the S & P 500 ended 2011 trading at only 13 times 2011's consensus earnings estimate of $97 and at only 12 times 2012's consensus earnings estimate of $103. This is pretty cheap relative to a long-term average price-earnings ratio of 15. Improving confidence in the outlook for continued economic and profit growth will be the key to lifting valuations. *Investors' lack of confidence in economic growth, corporate profit forecasts and the actions of policymakers is likely already fully reflected in the markets and creates the potential for valuations to rise as confidence rebounds from multi-decade lows.*

Current Portfolio Positioning- Focus on Dividend-Paying Stocks

The typical MAM portfolio is currently invested with a somewhat conservative asset allocation of approximately 46% U.S. stocks, 11% international stocks, 37% bonds and cash and 6% alternative assets. I estimate the beta to be around .65, meaning the typical portfolio is estimated to have 65% of the volatility of the S & P 500. The 12-month yield is 3.4% and the average expense ratio of the mutual funds and ETFs is 0.73. The most prevalent theme is a focus on dividend-paying stocks.

Here are comments regarding the specific assets classes used:

1. **U.S. Equity Funds:** Last month Morningstar announced five nominees for 2011 Domestic-Stock Manager of the Year. Of the five, three are used in most MAM portfolios: Artisan Mid-Cap Value, FMI Large Cap and Yacktman. The remaining U.S. equity funds include Vanguard Dividend Appreciation, an ETF that is my favorite dividend-focused fund, N & B Genesis, which is a very good mid-cap fund, and Blackrock Health Science, which is my favorite health care fund.

2. **Bond Funds:** The bond funds used by MAM invest primarily in high-quality corporate, mortgages, high-yield and foreign bonds. There is little exposure to U.S. Treasuries, which I feel will perform very poorly once interest rates eventually start to rise. The largest bond fund is

from Jeffrey Gundlach's DoubleLine Funds, which according to Investment News, was the best performing mutual fund family in 2011.

3. **International Equities:** The two largest international funds are both dividend-focused funds. Matthews New Asia has a current yield of 4.0% and invests in dividend-paying Asian stocks and Thornburg Investment Income has a current yield of 6.8% and invests in stocks and bonds throughout the world.

4. **Alternative Assets:** The investments here are the Permanent Portfolio, PIMCO Commodity and the recently added high-yielding ETN from JP Morgan that invests in Master Limited Partnerships.

Assets Under Management and Referrals

As of December 31, 2011, MAM assets under management were over $110 million, up from $103 million at the beginning of 2011. I want to thank those of you who have added to their investments or have referred the services of McCarthy Asset Management, Inc. to their friends and family. I really appreciate this as referrals are our primary source of new clients. While our minimum amount to manage for new clients is $500,000, I am willing to be flexible depending on the individual's situation.

Please call me if you wish to discuss the stock market or your portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA, CFP®

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